Supreme Court, U. S.
FILED
OCT 14 1976
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 75-1285

UNITED STATES OF AMERICA, *Petitioner*

v.

PENN SECURITY LIFE INSURANCE COMPANY, *Respondent*

On a Writ of Certiorari to the United States Court of Claims

BRIEF FOR RESPONDENT

JOHN T. SAPIENZA
JOHN B. JONES, JR.
ANDREW W. SINGER

Of Counsel:

COVINGTON & BURLING
888 Sixteenth Street, N.W.
Washington, D. C. 20006

Attorneys for Respondent

OWEN T. ARMSTRONG, ESQ.
LOWENHAUPT, CHASNOFF, FREEMAN, ARMSTRONG & MELITZ
408 Olive Street
St. Louis, Missouri 63102

ROBERT A. KAGAN, ESQ.
320 Park Avenue
New York, New York 10022

JOSEPH KUTTEN, ESQ.
212 South Central Avenue
Clayton, Missouri 63105

INDEX

Page

QUESTIONS PRESENTED 1

STATUTES AND REGULATIONS INVOLVED 2

STATEMENT 8

SUMMARY OF ARGUMENT 16

ARGUMENT 21

I. PETITIONER'S OWN REGULATIONS ARE DISPOSITIVE OF THIS CASE 21

A. Respondent Did Not Receive Premiums "Paid in Advance" From Pilot and National Fidelity as Required by Treas. Reg. Section 1.801-3(e) 24

B. Respondent Did Not "Actually Hold" Unearned Premium Reserves in Respect of Its Treaties With Pilot and National Fidelity as Required by Treas. Reg. Section 1.801-5(a) 27

C. The Unearned Premiums Attributed to Respondent Were Neither Reported by Respondent on Its Annual Statements Nor Accepted by State Regulatory Officials of Missouri as Required by Treas. Reg. Section 1.801-5(b) 31

II. THE STATUTE AND REGULATIONS DEFINE A LIFE INSURANCE COMPANY IN TERMS OF RESERVES HELD, NOT RISKS ASSUMED 36

A. It Was Not the Purpose of Congress To Go Beyond the Reserves Actually Held by a Company To Determine the Nature of Its Business 36

Page

B. Mandatory Attribution Is Inconsistent With the Optional Attribution Rules Prescribed by Congress in Section 820, and With the Internal Revenue Service's Position in Rev. Rul. 70-508 39

C. Petitioner Misapplied Its Reserves Follow the Risk Rule by Attributing Gross Rather Than Unearned Net Premiums to Respondent 42

D. If There Is To Be Any Modification in the Section 801 Reserve Test, It Should Be Made by Congress on a Prospective Basis 45

III. Petitioner May Not Recast for Tax Purposes Transactions Between Unrelated Parties Having Significant Non-Tax Consequences 53

A. Petitioner's Contention That Pilot and National Fidelity Were Merely "Paymasters" Holding Unearned Premiums "On Behalf" of Respondent Is Contrary to the Court of Claims' Findings and the Facts of Record.. 53

B. Unearned Premiums Cannot Be Attributed to Respondent Under the Doctrine of Constructive Receipt 57

Conclusion 61

CITATIONS

Cases:

Alinco Life Insurance Co. v. *United States,* 373 F.2d 336 (Ct. Cl. 1967) 15, 30, 43, 45, 46
Brafman v. *United States,* 384 F.2d 863 (5th Cir. 1957) 23
Commissioner v. *Brown,* 380 U.S. 563 (1965) 50, 51
Commissioner v. *First Security Bank,* 405 U.S. 394 (1972) 53, 54, 55, 56
Commissioner v. *Estate of Bosch,* 387 U.S. 456 (1967) 33
Commissioner v. *Hansen,* 360 U.S. 446 (1959) 59
Commissioner v. *Idaho Power Co.,* 418 U.S. 1 (1974).. 30

Page

Commissioner v. *Lincoln Savings & Loan Association*, 403 U.S. 345 (1971) 30
Commissioner v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974) 56
Commissioner v. *Oates*, 207 F.2d 711 (7th Cir. 1953).. 58
Commissioner v. *South Texas Lumber Co.*, 333 U.S. 496 (1948) 23
Consumer Life Insurance Co. v. *United States*, 524 F.2d 1167 (Ct. Cl. 1975), *cert. granted*, 44 U.S. L.W. 3670 (May 25, 1976) 14, 15, 16, 34
Economy Finance Corp. v. *United States*, 501 F.2d 466 (7th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975) 13, 14, 18, 34, 36, 37, 38, 43, 47, 49, 56, 57, 58
Edwards v. *Commissioner*, 415 F.2d 578 (10th Cir. 1969) 55
Fawcus Machine Co. v. *United States*, 282 U.S. 375 (1931) 23
First Railroad & Banking Co. v. *United States*, 514 F.2d 675 (5th Cir. 1975), *cert. granted*, 44 U.S. L.W. 3670 (May 25, 1976) 14, 15, 16, 34
Fribourg Navigation Co. v. *Commissioner*, 383 U.S. 272 (1965) 23
Great Commonwealth Life Ins. Co. v. *United States*, 491 F.2d 109 (5th Cir. 1974) 43, 48
Gregory v. *Helvering*, 293 U.S. 465 (1935) 21
Hanover Bank v. *Commissioner*, 369 U.S. 672 (1962) 23
Helvering v. *Oregon Life Ins. Co.*, 311 U.S. 267 (1940) 23, 39, 45
Helvering v. *R. J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939) 23
Knetsch v. *United States*, 364 U.S. 361 (1960) 56
Lamana-Panno-Fallo Industrial Insurance Co. v. *Commissioner*, 127 F.2d 56 (5th Cir. 1942) 29
Lewis & Taylor, Inc. v. *Commissioner*, 447 F.2d 1074 (9th Cir. 1971) 54, 55
Lynch v. *Alworth-Stephens Co.*, 267 U.S. 364 (1925) .. 39
Maryland Casualty Co. v. *United States*, 251 U.S. 342 (1920) 28, 30, 33
McCord v. *Granger*, 201 F.2d 103 (3d Cir. 1952) 23
Morton v. *Ruiz*, 415 U.S. 199 (1974) 52
Nassau Lens Co. v. *Commissioner*, 308 F.2d 39 (2d Cir. 1962) 55

Page

National Protective Insurance Co. v. *Commissioner*, 128 F.2d 948 (8th Cir. 1942) 30
Old Colony Railroad Co. v. *Commissioner*, 284 U.S. 552 (1932) 39
Pacific National Bank v. *Commissioner*, 91 F.2d 103 (9th Cir. 1937) 23
Ray S. Robinson, 44 T.C. 20 (1965), *acq.* 1970-2 Cum. Bull. xxi 58
Santa Anita Consolidated, Inc., 50 T.C. 536 (1968), *acq.* 1969-2 Cum. Bull. xxv 54
State ex rel. American Central Insurance Co. v. *Gehner*, 320 Mo. 901, 9 S.W.2d 621 (1928) 33
Superior Life Insurance Co. v. *United States*, 462 F.2d 945 (4th Cir. 1972) 16, 43, 58
United States v. *Leslie Salt Co.*, 350 U.S. 383 (1956) .23, 52
Vogt v. *United States*, 537 F.2d 405 (Ct. Cl. 1976) ... 52
Oliver G. Willits, 50 T.C. 602 (1968), *acq.* 1969-1 Cum. Bull. 21 58

STATUTES, REGULATIONS AND RULINGS:

Internal Revenue Code of 1954

Part I, Subchapter L, Chapter 1 .....45, 46
Section 482 .....16, 23
Section 514 52
Section 801 ....16, 17, 18, 21, 22, 23, 28, 31, 33, 40, 41, 42
Section 805 49
Section 809 49
Section 810(c) 49
Section 815(d) 38, 52
Section 820 .....39, 40, 52

Life Insurance Company Income Tax Act of 1959
73 Stat. 112 .....37, 39
Revenue Act of 1921, 42 Stat. 227, Section 242...23, 28, 36
5 United States Code § 552(a) 52
Treasury Regulations on Income Tax (26 C.F.R.):

Section 1.167(b)-3 29
Section 1.451-1(a) 59
Section 1.451-2(a) 58
Section 1.801-3 .....13, 17, 22, 24, 25, 42, 43, 46, 49, 59

Page

Section 1.801-4 ..... 41, 42
Section 1.801-5 ..... 17, 22, 28, 33
Section 1.809-4(a) 53
Section 1.809-5(a) 53

Regulations 62, Art. 681 (1922 ed.) 28

REVENUE RULINGS:

Rev. Rul. 60-31, 1960-1 Cum. Bull. 174 58
Rev. Rul. 67-316, 1967-2 Cum. Bull. 171 60
Rev. Rul. 70-508, 1970-2 Cum. Bull. 136 ..... 39, 40, 41, 48
Rev. Rul. 72-115, 1972-1 Cum. Bull. 200 15

MISCELLANEOUS:

H.R. Rep. No. 350, 67th Cong., 1st Sess. (1921) 36
H.R. Rep. No. 2333, 77th Cong., 2d Sess. (1942) 26, 44
S. Rep. No. 275, 67th Cong., 1st Sess. (1921) 36
S. Sep. No. 291, 86th Cong., 2d Sess. (1959) 40
Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance,* 77 Yale L.J. 440 (1968) 55
Eilers & Crowe, *Group Insurance Handbook* (1965) 25-26
Hammond, *Insurance Accounting, Fire and Casualty* (2d ed. 1965) 47
8 Mertens, *Law of Federal Income Taxation* (1970 revision) 26, 46
National Association of Insurance Commissioners, *Examiners' Handbook* (1970 ed.) 27
Thompson, *Reinsurance* (4th ed. 1966) 35

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 75-1285

UNITED STATES OF AMERICA, *Petitioner*

v.

PENN SECURITY LIFE INSURANCE COMPANY, *Respondent*

On a Writ of Certiorari to the United States Court of Claims

BRIEF FOR RESPONDENT

QUESTIONS PRESENTED

Where "bona fide reinsurance agreements" do not entitle a reinsurer to receive premiums "paid in advance" for insurance coverage in future periods from the companies it reinsures, may the Internal Revenue Service include "unearned premiums" with respect to such agreements in the reinsurer's reserves in disregard both of its own Regulations, Treas. Reg. Sections 1.801-3(e), 1.801-5(a)(3), 1.801-5(b), and the regulatory requirements of state law?

Does either Section 801 of the Internal Revenue Code or the doctrine of "substance over form" justify attri-

bution of unearned premium reserves from reinsured companies to an unrelated reinsurer where, under bona fide reinsurance agreements, the reinsured companies actually hold the reserves in satisfaction of contractual and statutory obligations to their policyholders, and the reinsurer has no right to hold, is not required to hold, and does not in fact hold those reserves at any time?

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954

Sec. 801. DEFINITION OF LIFE INSURANCE COMPANY

(a) LIFE INSURANCE COMPANY DEFINED.—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

* * *

(c) TOTAL RESERVES DEFINED.—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency reserves (within the meaning of subsection (b)(4)).

* * *

Sec. 820. OPTIONAL TREATMENT OF POLICIES REINSURED UNDER MODIFIED COINSURANCE CONTRACTS

(a) IN GENERAL.—

(1) TREATMENT AS REINSURED UNDER CONVENTIONAL COINSURANCE CONTRACT.—Under regulations prescribed by the Secretary or his delegate, an insurance or annuity policy reinsured under a modified coinsurance contract (as defined in subsection (b)) shall be treated, for purposes of this part (other than for purposes of section 801), as if such policy were reinsured under a conventional coinsurance contract.

(2) CONSENT OF REINSURED AND REINSURER.—Paragraph (1) shall apply to an insurance or annuity policy reinsured under a modified coinsurance contract only if the reinsured and reinsurer consent, in such manner as the Secretary or his delegate shall prescribe by regulations—

(A) to the application of paragraph (1) to all insurance and annuity policies reinsured under such modified coinsurance contract, and

(B) to the application of the rules provided by subsection (c) and the rules prescribed under such subsection.

Such consent, once given, may not be rescinded except with the approval of the Secretary or his delegate.

(b) DEFINITION OF MODIFIED COINSURANCE CONTRACT.—For purposes of this section, the term "modified coinsurance contract" means an indemnity reinsurance contract under the term of which—

(1) a life insurance company (hereinafter referred to as "the reinsurer") agrees to indemnify another life insurance company (hereinafter referred to as "the reinsured") against a risk assumed by the reinsured under the insurance or annuity policy reinsured,

(2) the reinsured retains ownership of the assets in relation to the reserve on the policy reinsured,

(3) all or part of the gross investment income derived from such assets is paid by the reinsured to the reinsurer as a part of the consideration for the reinsurance of such policy, and

(4) the reinsurer is obligated for expenses incurred, and for Federal income taxes imposed, in respect of such gross investment income.

(c) SPECIAL RULES.—Under regulations prescribed by the Secretary or his delegate, in applying subsection (a)(1) with respect to any insurance or annuity policy the following rules shall (to the extent not improper under the terms of the modified coinsurance contract under which such policy is reinsured) be applied in respect of the amount of such policy reinsured:

(1) * * *:

(2) * * *;

(3) RESERVES AND ASSETS.—The reserve on the policy reinsured shall be treated as a part of the reserves of the reinsurer and not of the

reinsured, and the assets in relation to such reserve shall be treated as owned by the reinsurer and not by the reinsured.

* * *

Treasury Regulations

Treas. Reg. Sec. 1.801-3.—Definitions.—

For purposes of part I, subchapter L, chapter 1 of the Code, this section defines the following terms which are to be used in determining if a taxpayer is a life insurance company (as defined in section 801(a) and paragraph (b) of this section):

* * *

(e) *Unearned premiums.* The term "unearned premiums" means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

(f) *Life insurance reserves.* For the definition of the term "life insurance reserves," see section 801(b) and § 1.801-4.

* * *

(h) *Total reserves.* For the definition of the term "total reserves," see section 801(c) and § 1.801-5.

* * *

Treas. Reg. Sec. 1.801-4.—Life insurance reserves.—

(a) *Life insurance reserves defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "life insurance reserves" (as defined in section 801(b)) means those amounts—

(1) Which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest;

(2) Which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies; and

(3) Which, except as otherwise provided by section 801(b)(2) and paragraphs (b) and (c) of this section, are required by law. For the meaning of the term "reserves required by law," see paragraph (b) of § 1.801-5. For purposes of determining life insurance reserves, only those amounts shall be taken into account which must be reserved either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute. Moreover, such amounts must actually be held by the company during the taxable year for which the reserve is claimed. However, reserves held by the company with respect to the net value or risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves. For example, if an ordinary life policy with a reserve of $100 is reinsured in another solvent company on a yearly renewable term basis, and the reserve on such yearly renewable term policy is $10 the reinsured company shall include $90 ($100 minus $10) in determining its life insurance reserves. Generally, life insurance reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient

to cover the increased risk in the later years. For examples of reserves which qualify as life insurance reserves, see paragraph (d) of this section. For examples of reserves which do not qualify as life insurance reserves, see paragraph (e) of this section.

Treas. Reg. Sec. 1.801-5.—Total reserves.—

(a) *Total reserves defined.* For purposes of section 801(a) and § 1.801-3, the term "total reserves" is defined in section 801(c) as the sum of—

(1) Life insurance reserves (as defined in section 801(b) and § 1.801-4),

(2) Unearned premiums (as defined in paragraph (e) of § 1.801-3), and unpaid losses (whether or not ascertained) (as defined in paragraph (g) of § 1.801-3), not included in life insurance reserves, and

(3) All other insurance reserves required by law. The term "total reserves" does not, however, include deficiency reserves (within the meaning of section 801(b)(4) and paragraph (e)(4) of § 1.801.-4), even though such deficiency reserves are required by State law. In determining total reserves, a company is permited to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held during the taxable year for which the reserve is claimed. For example, during the taxable year 1958 a life insurance company sells life insurance and annuity contracts in States A and B. State A requires reserves of 10 against the life and 5 against the annuity business. State B requires reserves of 9 against the life and 7 against the annuity

business. Assuming the company actually holds these reserves during the taxable year 1958, its highest aggregate reserve for such taxable year is the 16 required by State B. Thus, the company is not permitted to compute its highest aggregate reserve by taking State A's requirement of 10 against its life insurance business and adding it to State B's requirement of 7 against its annuity business.

(b) *Reserves required by law defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

* * *

STATEMENT

In this Federal income tax case, petitioner seeks reversal of a judgment of the United States Court of Claims that respondent, Penn Security Life Insurance Company, was entitled to compute its income tax for the years 1963, 1964 and 1965 under Internal Revenue Code provisions applicable to life insurance companies. It is no longer disputed that respondent qualified as a life insurance company in 1965 because petitioner does not take exception to that part of the Court's decision holding that the Internal Revenue Service erroneously disallowed life insurance reserves claimed by respondent for that year.

The remaining question is whether respondent's life insurance reserves comprised more than 50 percent of its total reserves during the years 1963 and 1964. Petitioner concedes they did if one looks to the reserves actually held by respondent and accepted by the insurance authorities of the State of Missouri who regulated respondent's business. Petitioner contends, however, that it is entitled to attribute "unearned premiums" to respondent that were actually held by two unrelated companies, the Pilot and National Fidelity life insurance companies, and that this attribution prevents respondent from qualifying for life insurance company status.

Respondent's principal business during these years consisted of reinsuring companies writing credit life insurance policies covering debtors of the Aetna Finance Company, respondent's parent company.[1] (Finding 4, Pet. App. 31a). These policies sometimes included accident and health as well as life insurance coverage, but life insurance benefits accounted for more than half the dollar value of all benefits reinsured by respondent. (Finding 13, Pet. App. 36a).

Pilot and National Fidelity were two of the companies that issued credit insurance policies covering Aetna's loan customers. (Finding 7, Pet. App. 32a-33a). In separate but substantially identical accident and

---

[1] Respondent could not write insurance directly on the debtors of Aetna Finance Company, which had 200 offices in approximately 25 states, because in these years respondent was only licensed to do business in the State of Missouri. (Ex. 24, A. 48, 101) By 1967, respondent's volume of business increased to the point at which it became more profitable for it to write its own credit insurance policies than to reinsure other companies. (Finding 4, Pet. App. 31a). As of December 31, 1968, respondent was authorized to transact insurance business in all states except Connecticut, New York and New Jersey. (Ex. 25, A. 48, 136-137).

health reinsurance treaties with the two companies, respondent agreed to reinsure 100 percent of their liability to pay accident and health benefits under these policies. (Finding 18, Pet. App. 40a). Pilot and National Fidelity (hereinafter sometimes referred to as the ceding companies) agreed to pay a reinsurance premium to respondent each month for accident and health reinsurance provided by respondent during the previous month, in an amount equal to 98 percent of the premiums they earned in that month under the disability provisions of their policies. (*Ibid.*)

The credit insurance sold by Pilot and National Fidelity to loan customers of Aetna was usually written for a term of two to three years, typically coextensive with the term of the debtor's loan. (Finding 5, Pet. App. 31a-32a). A separate, single premium for accident and health coverage (when provided) was charged in advance for the entire period, payable at the inception of the policy term. (Finding 8, Pet. App. 33a).

By collecting disability premiums in advance, Pilot and National Fidelity incurred contractual and statutory obligations to their policyholders to provide insurance coverage, pay claims, and refund the advance premiums if a policy was canceled or otherwise terminated prior to the end of its term. (Findings 16 and 19, Pet. App. 38a-39a, 43a-44a). Pilot and National Fidelity were required by law to set aside unearned premium reserves on these policies; *i.e.*, funds equal to that portion of premiums collected in advance from their policyholders which they would have to refund if all their policies were canceled at once. (Findings 11, 16, and 19, Pet. App. 35a, 38a-39a, 43a-44a).

The unearned premium reserves which petitioner seeks to attribute to respondent were actually held by Pilot and National Fidelity and were included in the annual statements which they filed with (and which were accepted by) the insurance authorities of the various states in which they did business. (Finding 16, Pet. App. 38a-39a). Respondent's agreement to reinsure Pilot and National Fidelity did not relieve those companies of their legal obligation to maintain unearned premium reserves on their policies covering Aetna's debtors. (Finding 19, Pet. App. 43a-44a). Pilot and National Fidelity would have been entitled to a credit under state law against their reserve liabilities had they actually transferred their reserves to respondent, but they were not required to and did not in fact do so. (Findings 16 and 19, Pet. App. 38a-39a, 43a-44a).

Respondent had no right to the unearned premium reserves which petitioner seeks to attribute from Pilot and National Fidelity. (Finding 16, Pet. App. 38a-39a). Those reserves were invested by Pilot and National Fidelity along with their other reserve funds for their own accounts. (*Ibid.*) The income from such investments belonged exclusively to Pilot and National Fidelity, not respondent. (*Ibid.*)

Respondent did not own or control Pilot or National Fidelity, nor did any of its affiliates. (*Ibid.*) At no time were the unearned premiums which petitioner seeks to attribute to respondent either credited, set apart, or otherwise made available for respondent's use. (*Ibid.*)

Since respondent did not receive premiums in advance for future insurance coverage from Pilot and National Fidelity, and held no premiums that it might be required to refund if its treaties were canceled or otherwise terminated, it was neither necessary nor ap-

propriate for respondent to maintain an unearned premium reserve under applicable state regulatory requirements and actuarial principles. (Findings 20, 21, 22 and 29, Pet. App. 44a-45a, 48a-49a).

None of the annual statements filed by respondent with the Missouri Division of Insurance reflected an unearned premium reserve liability in respect of its disability reinsurance treaties with Pilot and National Fidelity or the policies issued by those companies. (Finding 26, Pet. App. 46a-47a). If an insurance company does not properly report its liabilities on its annual statements, state insurance examiners will recompute its liabilities in accordance with actuarial standards and governing state law and regulations. (Finding 27, Pet. App. 47a). Respondent's annual statements were audited and accepted by the Missouri Division of Insurance as well as by examiners from Maryland, Wyoming, and California. (Findings 28 and 29, Pet. App. 47a-49a). No state regulatory authority would impose an unearned premium reserve requirement on an insurance company where, as under respondent's disability reinsurance treaties with Pilot and National Fidelity, such company did not receive premiums in advance for insurance to be provided in the future. (Finding 29, Pet. App. 48a-49a).

These findings are repeated in some detail because petitioner's brief frequently relies on assertions that are simply contrary to the facts found by the Court of Claims, often without acknowledging the inconsistency. The findings make abundantly clear, for example, that the role of Pilot and National Fidelity in these transactions was not merely that of a "paymaster" or banker holding funds "on behalf of" respondent. (See Pet.

Br. 31, 36-37, 50). Further, Missouri law did not require respondent to establish an unearned premium reserve as petitioner contends. (Pet. Br. 66-75). The Court of Claims stated and explained in at least four different findings that respondent was not required to maintain an unearned premium reserve under either state law or actuarial principles.

The Court of Claims' findings were made on a record of facts and exhibits that petitioner stipulated to almost in their entirety. Findings regarding state regulatory reserve requirements and actuarial principles were based principally upon the testimony of an expert witness who petitioner stipulated was "familiar with the standard valuation laws in force in all 50 states, and with the requirements and examination procedures of the National Association of Insurance Commissioners." The facts and theories petitioner now espouses were never supported by testimony or other evidence in the trial below, which of course would have made them subject to cross-examination and rebuttal by respondent. Not only are the Court of Claims' findings not "clearly erroneous"; there is *nothing* in the record to contradict them.

The Court of Claims held that including unearned premiums in respondent's reserves would be inconsistent with petioner's own Regulations since respondent did not receive reinsurance premiums "paid in advance" from Pilot and National Fidelity as required by Treas. Reg. Section 1.801-3(e). The Court rejected the attribution theory accepted by the Seventh Circuit in *Economy Finance Corp.* v. *United States*, 501 F.2d 466 (7th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975), but it did not believe *Economy Finance* was decided on

"similar facts" as petitioner erroneously suggests. Because of side agreements in that case which gave the taxpayers' stockholders actual possession of the unearned premiums (including the income therefrom), the Court of Claims found the arrangement in *Economy Finance* "quite different from the one involved in the case at bar." (Pet. App. 15a-16a).

The facts of this case are also different in critical respects from *Consumer Life Insurance Co.* v. *United States*, 524 F.2d 1167 (Ct. Cl. 1975), *cert. granted*, 44 U.S.L.W. 3670 (May 25, 1976) and *First Railroad & Banking Co.* v. *United States*, 514 F.2d 675 (5th Cir. 1975), *cert. granted*, 44 U.S.L.W. 3670 (May 25, 1976), cases that have been consolidated for argument with *Penn Security*. Petitioner's brief blurs the factual differences between these cases and confuses the record in one case with that of another. It is important, therefore, that significant differences in the records of these three cases be set forth here.

1. Respondent is a reinsurer which entered into what petitioner concedes were "bona fide reinsurance agreements" with unrelated companies. (Pet. Br. 54, 74). It is not disputed that respondent never received nor actually held unearned premiums under its agreements with Pilot and National Fidelity, the ceding companies.

In *First Railroad & Banking Co.*, and in Treaty II in *Consumer Life*, direct insurers actually received unearned premiums from their policyholders. The insurers' position in these cases is that the unearned premiums were transferred to reinsurers and therefore were not includible in their reserves. Contrary to its position in *Penn Security*, petitioner contends that

these reinsurance agreements were not "bona fide". Petitioner's sweeping "reserves follow the risk" rule is wrong as a matter of law, but petitioner could still prevail under traditional "substance over form" doctrine in *First Railroad* and under Treaty II in *Consumer Life* if the facts justified its contention that those treaties were not really reinsurance agreements.

2. The Court of Claims found that respondent would qualify as a life insurance company even under a reserves follow the risk rule if attribution was limited to unearned *net* premiums representing the "cost of carrying the insurance risk" on Pilot's and National Fidelity's policies (Findings 32 and 34, Pet. App. 50a, 52a).[2] This finding, absent from both *Consumer Life* and *First Railroad,* is especially significant because Treasury regulations define "unearned premiums" as the amounts necessary to cover "the cost of carrying the insurance risk." Treas. Reg. Section 1.801-3(e).

3. More than half the dollar value of the credit insurance benefits reinsured by respondent were life insurance benefits. There was no such finding in *Consumer Life* or *First Railroad.* Since petitioner would disqualify respondent from life insurance company tax status though its actual reserves and principal business were both predominantly life insurance, this case best

---

[2] For 1964, this is subject to the condition that respondent be able to include unpaid losses on credit life insurance in the numerator and denominator of the reserve test. The Court of Claims has previously indicated that this is the proper treatment for unpaid losses on credit life insurance. *See* Alinco Life Ins. Co. v. United States, 373 F.2d 336, 354 (Ct. Cl. 1967). Despite the seemingly plain language of the statute, the Internal Revenue Service takes a contrary view. *See* Rev. Rul. 72-115, 1972-1 Cum. Bull. 200.

illustrates that its "reserves follow the risk" rule is arbitrary and capricious.

4. Neither of the ceding companies was owned or controlled, directly or indirectly, by respondent or its affiliated companies. This was also true in *Consumer Life,* while the unearned premiums in *First Railroad* were held by an affiliated company. *Cf.* Section 482, Int. Rev. Code of 1954; *Superior Life Insurance Co.* v. *United States,* 462 F.2d 945 (4th Cir. 1972).

5. Petitioner introduced no evidence to support its theory, first advocated in the *en banc* rehearing below, that respondent was required by state law to establish unearned premium reserves. It did introduce such evidence in *First Railroad* and *Consumer Life,* though the evidence was disregarded in the former case and explicitly rejected in the latter.

SUMMARY OF ARGUMENT

Section 801(a) of the Internal Revenue Code provides that if an insurance company's life insurance reserves (not in dispute here) comprise more than 50 percent of its "*total reserves*", defined in Section 801 (c) as including "*unearned premiums*" and other insurance reserves *required by law*", it is to be considered a "life insurance company" for tax purposes. (Emphasis added). Respondent met this test on the basis of the reserves it actually held, computed in accordance with generally accepted actuarial principles and the reserve requirements of state law.

The issue is whether petitioner may take unearned premiums held by Pilot and National Fidelity in sat-

isfaction of *their* contractual and statutory obligations to *their* policyholders and "attribute" them to respondent in such manner that respondent's life insurance reserves no longer comprise 50 percent of the inflated "total reserves" figure produced by petitioner's attribution.

Treasury Regulations "to be used in determining if a taxpayer is a life insurance company," contain the definitions and requirements for applying the Section 801(a) reserve test. *See* Treas. Reg. Section 1.801-3. Three different sections of those Regulations prohibit petitioner from attributing "unearned premiums" to respondent as it seeks to do in this case.

First, the Regulations (Treas. Reg. Section 1.801-3 (e)) define the term "unearned premiums" as "those amounts which shall cover the cost of carrying the insurance risk *for the period for which the premiums have been paid in advance.*" (Emphasis added). Respondent never received and never had any right to receive accident and health premiums "paid in advance" for any period from Pilot, National Fidelity, or their policyholders, and so cannot be charged with "unearned premiums."

Second, every reserve included in "total reserves" must have been "actually held during the taxable year for which the reserve is claimed." Treas. Reg. Section 1.801-5(a). Respondent never held and was never required to hold unearned premium reserves with respect to its reinsurance of Pilot and National Fidelity.

Finally, if the unearned premiums are to be described as "other insurance reserves required by law," Treas. Reg. Section 1.801-5(b) states that they must

have been "reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries." Respondent did not report the "attributed" unearned premium reserves in its annual statements and state regulatory authorities never required or even suggested that it do so.

Petitioner cannot avoid the result plainly required by its own Regulations by redefining the terms of Section 801 to suit its purpose here, without even acknowledging the contrary provisions of the Regulations in its brief.[3] Regulations standing as authoritative interpretations of the Section 801 reserve test for as long as 50 years are as binding on the Government as they are on taxpayers.

The Seventh Circuit's decision to rewrite Section 801 in *Economy Finance*, a case in which the facts may have compelled attribution under the "constructive receipt" doctrine in any event, should not be followed here. One problem with that decision is that it analyzed the Congressional purpose behind the reserve test in terms of the statutory scheme created by Congress in 1959, while the reserve test was enacted under a different scheme in 1921. Another problem is that the Seventh Circuit was badly misinformed about the 1959 scheme. A final problem is that when courts

---

[3] We find only a reference to the Court of Claims' reliance on the Regulations' definition of "unearned premiums" in footnote 18 on page 59 near the end of petitioner's brief. There is also a critically incomplete quotation on pages 66-67 from the Regulation defining reserves "required by law" that omits the embarrassing requirement that such reserves must be reported to and accepted by state regulatory authorities.

rewrite complicated statutes, they often create more problems than they solve.

Nothing in the legislative record indicates a Congressional intention to allow the Internal Revenue Service to disregard the decision of state regulatory authorities on reserve requirements and attribute reserves to any company that has assumed a risk. On the contrary, in 1959 Congress passed special legislation for "modified coinsurance" transactions substantially similar to the reinsurance agreements involved in this case which permits the ceding company and the reinsurer the *option* of electing reserve attribution but does not give the Government authority to require such attribution. In fact, the Internal Revenue Service has ruled that the reserve on reinsured risks in such cases is properly included in the ceding company's reserves, not the reserves of the reinsurer.

Application of the Code and regulations as written does not produce absurd results in this case, or results which one can say are clearly contrary to the legislative purpose. Petitioner's rule, on the other hand, would prevent respondent from qualifying as a life insurance company though more than half the dollar value of benefits it reinsured were life insurance benefits, more than half of the cost of insurance risks were attributable to life insurance, and more than half the reserves it held in full compliance with state law were life insurance reserves.

One reason for this strange result is that petitioner's application of its "reserves follow the risk" rule is not consistent with the rationale it urges on the Court. It argues that respondent should not exclude reserves representing "estimated policy claims" from its non-

life insurance business but attributes unearned *gross* premium reserves to respondent, including reserves for overhead expenses and profit, that are approximately three times the amount necessary to satisfy all estimated claims on the reinsured policies. Thus, petitioner is not only inconsistent but unfair; it disqualifies respondent from life insurance company status by putting its thumb on the non-life side of the scale.

The reserve test has worked so well and long that any significant change in its application should be approved by Congress. This court has deemed it a wise policy to defer to Congress to fashion rules dealing with real or imagined defects in the tax law, and that is particularly appropriate in the technical, specialized field of life insurance company taxation. If Congress wants to change to a "risk" rather than reserve comparison, it can do so in a way that would not deprive companies underwriting principally life insurance benefits of life insurance company status. Equally important, Congress can act on a prospective basis that will not upset reasonable expectations of taxpayers engendered by petitioner's own Regulations.

There is no merit in petitioner's argument that, "in substance", Pilot and National Fidelity were merely respondent's agents, holding unearned premium reserves on its behalf. The Court of Claims' findings, based on uncontradicted evidence, are to the contrary. Only Pilot and National Fidelity were liable to their policyholders; only they maintained and invested the reserve funds; only they retained the income from the reserves. The reserves were never credited, set apart, or made available to respondent.

Petitioner invokes this Court's landmark decision in *Gregory* v. *Helvering,* 293 U.S. 465 (1935), and a string of other "substance over form" tax cases. But there is an equally respectable line of decisions, also headed by *Gregory,* holding that taxpayers are not required to arrange their business affairs in a way which produces the greatest tax for the Commissioner of Internal Revenue, or accept the Commissioner's offer to produce that result for them *ex post facto.* The latter doctrine is generally preferred where, as here, the Commissioner seeks to restructure a transaction between unrelated parties into a form that would have had very different legal and economic consequences.

ARGUMENT

I. PETITIONER'S OWN REGULATIONS ARE DISPOSITIVE OF THIS CASE.

Respondent qualified as a "life insurance company" under Section 801(a) because *"its"* life insurance reserves comprised more than 50 percent of *"its"* total reserves as the terms of the statute require. In calculating its reserve test for the years in issue, respondent took into account all the reserves it actually held and reported on its annual statements to the Missouri insurance authorities, which later accepted those reserves as completely satisfying the State's regulatory reserve requirements. In this and all other respects, respondent fully complied with the definitions and requirements of the Internal Revenue Service as set forth in its Regulations.

The additional unearned premiums petitioner seeks to "attribute" to respondent were not *its* unearned premiums; it had no right to them, was not required to hold them, and in fact never held them. Respondent did not have even a theoretical liability to establish an unearned premium reserve to meet accident and health risks under Pilot's and National Fidelity's policies. The insurance industry and its state regulators regarded the liability to maintain unearned premium reserves and the funds actually held in satisfaction of that liability as properly belonging to Pilot and National Fidelity, not respondent.

The same conclusion is compelled by the Treasury Regulations promulgated for use "in determining if a taxpayer is a life insurance company." *See* Treas. Reg. Section 1.801-3. Those Regulations treat the unearned premium reserve as belonging to the company that receives premiums "paid in advance" for insurance coverage in future periods, that "actually holds" the reserve during the taxable year, and that reports the reserve on its annual statements to state insurance authorities. *See* Treas. Reg. Sections 1.801-3(e); 1.801-5(a)(3); 1.801-5(b). Pilot and National Fidelity met all of these tests; respondent met none.

Petitioner contends that attribution of reserves from a reinsured company to its reinsurer is supported by the terms of Section 801[4] but, in making that argument, petitioner defines those terms quite differently from the definitions in its own Regulations. The "reserves follow the risk" rule for which it contends,

---

[4] The terms of Section 801 plainly do not authorize attribution of reserves from one insurance company to another. When Congress wanted to give the Internal Revenue Service the power of realloca-

first being advocated some 50 years after enactment of the Section 801(a) reserve test in 1921,[5] has never been included or even proposed as part of the official Regulations interpreting Section 801. It is in fact an exercise in expediency rather than interpretation, an afterthought to justify disqualification of the credit insurance companies in these cases from life insurance company status.

Treasury Regulations may not be discarded simply because they do not suit petitioner's purpose in a particular case. They are always entitled to great weight in construing the statute, *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948); *Fawcus Machine Co.* v. *United States*, 282 U.S. 375, 378 (1931); and are binding on the Government as well as taxpayers. *See Brafman* v. *United States*, 384 F.2d 863, 866 (5th Cir. 1957); *McCord* v. *Granger*, 201 F.2d 103, 106-107 (3d Cir. 1952); *Pacific Nat'l Bank* v. *Commissioner*, 91 F.2d 103, 105 (9th Cir. 1937). "Against the Treasury's prior long-standing and consistent administrative interpretation, [petitioner's] more recent *ad hoc* contention as to how the statute should be construed cannot stand." *United States* v. *Leslie Salt Co.*, 350 U.S. 383, 396 (1956). *See also Fribourg Navigation Co.* v. *Commissioner*, 383 U.S. 272, 283 (1965); *Hanover Bank* v. *Commissioner*, 369 U.S. 672, 686 (1962); *Helvering* v. *Oregon Ins. Co.*, 311 U.S. 267 (1940); *Helvering* v. *R.J. Reynolds Tobacco Co.*, 306 U.S. 110, 114-115 (1939).

---

tion, it did so expressly in Section 482 of the Code. That Section permits attribution only between related parties and it is stipulated here that Pilot and National Fidelity were not owned or controlled, directly or indirectly, by respondent.

[5] *See* Section 242 of the Revenue Act of 1921, 42 Stat. 227, 261.

A. Respondent Did Not Receive Premiums "Paid in Advance" From Pilot and National Fidelity as Required by Treas. Reg. Section 1.801-3(e).

Treas. Reg. Section 1.801-3(e) defines the term "unearned premiums" as:

> "those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been *paid in advance.*" (Emphasis added.)

Respondent is not chargeable with "unearned premiums" from Pilot and National Fidelity because it had no right to receive and did not in fact receive premiums "paid in advance" for any future period from Pilot or National Fidelity or their policyholders.[6]

Petitioner offers a new definition in which "the phrase 'unearned premiums' . . . refers to the unearned premium *reserve* that reflects an insurance company's liability to meet casualty insurance claims." (Pet. Br. 41) (emphasis in original). Arguing from this premise, petitioner contends that since respondent agreed to reinsure accident and health risks assumed by Pilot and National Fidelity, it had the "ultimate" liability to pay their insurance claims and is required to reflect that liability in its reserves.

---

[6] Petitioner argues that since respondent undertook to reimburse the ceding companies for all claims paid, those companies did not bear the "cost of carrying the insurance risk" for any period (Pet. Br. 59, fn. 18.) That is irrelevant (the ceding companies' reserves are not in issue here) but also factually and legally incorrect since respondent's agreement to reinsure the ceding companies did not release them from their obligations to their policyholders. See p. 11, *supra.*

The issue actually posed by petitioner's Regulations, however, is not whether respondent agreed to reinsure risks in the future, but whether respondent was *paid in advance* for reinsuring risks in the future. The Regulations do not refer to unearned premiums as a liability to be imputed to any company which has agreed to insure or reinsure a risk. The insured or ceding company must have paid in advance for its insurance coverage in future periods or there are no "unearned premiums."[7]

Petitioner seeks only to confuse the issue by distinguishing unearned premium dollars, an asset, from the unearned premium reserve, a liability. There is no important distinction between the two because, as the popular song goes, "you can't have one without the other." Whether the Regulations refer to an asset or a liability, the Court must look to the mode of premium payment to determine whether a company has received unearned premiums for which a reserve is required. Treas. Reg. Section 1.801-3(e). *See* Findings 20, 22 (Pet. App. 44a-45a); Eilers & Crowe (ed.), *Group*

---

[7] The expert witness in this case testified that "it would be impossible to have an insurance operation" if insurance companies were required to establish a liability based on premiums to be paid in the future but not yet received. A. 182. In the case of life insurance, for example, the reserve liability is based on the difference between the *present value* of future claims expected to be paid and the *present value* of premiums to be received. If this test had been applied to respondent's accident and health reinsurance treaties with the ceding companies, under any reasonable assumption as to future claims, the present value of future reinsurance premiums would have exceeded the present value of probable claims. (Finding 21, Pet. App. 44a). Thus respondent had no reserve "liability" either under the traditional unearned premium reserve method or the future risk approach that petitioner advocates here.

Insurance Handbook 1965 8 Mertens, *Law of Federal Income Taxation* (1970 revision), § 44.28.[8]

The Regulations' requirement that unearned premiums be "paid in advance" is taken (along with the rest of the definition of "unearned premiums") from a House Ways and Means Committee Report. *See* H.R. Rep. No. 2333, 77th Cong., 2d Sess. (1942), 109, quoted at pp. 43-44, *infra*. This is far stronger evidence of the Congressional understanding of "unearned premiums" than anything petitioner has been able to muster in support of its "reserves follows the risk" rule.

The "paid in advance" requirement is an indispensable element of the definition of "unearned pre-

---

[8] Petitioner conceded below that unearned premiums held by another company reinsured by respondent, Old Republic Life Insurance Company, could not be attributed to respondent under Section 801. The terms of the Old Republic disability reinsurance treaty were substantially identical to the Pilot and National Fidelity treaties, including the monthly earned premium mode of payment. Unlike the Pilot and National Fidelity treaties, however, there was no "run-off provision" in the Old Republic treaty which obligated respondent, in the event of cancellation of the treaty, to continue the treaty in force with respect to any policies issued by the reinsured companies prior to the date of cancellation. The presence of a run-off provision in the Pilot and National Fidelity treaties might have significance if unearned premium reserves were really calculated solely on the basis of the liability an insurance company agrees to assume in the future, but that is not the way either the Regulations or the insurance industry defines the term. The expert in this case commented specifically on the irrelevance of a run-off provision in computing an unearned premium reserve, concluding that:

> "[Under] all of these treaties [that is, Old Republic, Pilot and National Fidelity], *even though they differ in the run-off provision*, the premium payments received by [respondent] were after the expiration of the period of coverage for which the premium was paid, and, therefore, . . . there could be no unearned premium reserve." A. 181. (Emphasis added.)

miums" because the unearned premium reserve has always been understood as the measure of a company's potential obligation to refund premiums not yet earned if all its policies were suddenly and prematurely cancelled. (Finding 11, Pet. App. 35a). Indeed, unearned premiums are more an accounting than an insurance concept; a recognition of services paid for but not yet provided. *See* National Association of Insurance Commissioners, *Examiners' Handbook* (1970 ed.), App. B, p. B13:

> "The basic reason [for an unearned premium reserve] is simply that it is proper accounting practice to establish a liability for *income received but not yet earned.*" (Emphasis added).[9]

Respondent never received a prepayment of premiums from Pilot and National Fidelity which it could be required to refund, nor was it liable for refunds to their policyholders. Hence, there was no need for respondent to establish an unearned premium reserve as that term has traditionally been understood in the insurance industry.

B. Respondent Did Not "Actually Hold" Unearned Premium Reserves in Respect of its Treaties with Pilot and National Fidelity as Required by Treas. Reg. Section 1.801-5(a).

Petitioner's new definition of "unearned premiums" requires the Court to accept the novel proposition that a "reserve" for purposes of Section 801 means or includes a theoretical reserve liability for which the

---

[9] Similarly, a landlord who rents a building for stipulated monthly rentals over a three-year period does not establish a liability merely because he is obligated to furnish the premises to the tenant over that period, but he would record any advance rentals as "unearned" or "prepaid" rent, until they were earned.

insurance company has not actually set aside any of its own funds. The suggestion that respondent ever had any such liability under its reinsurance agreements with Pilot and National Fidelity is contrary to the findings of the Court of Claims and the uncontradicted facts of record. See pp. 31-36, *infra*. But even if respondent had a liability for which it concededly set aside no funds, that would not constitute a "reserve" for purposes of Section 801.

This Court recognized long ago in *Maryland Casualty Co.* v. *United States*, 251 U.S. 342 (1920), that the term "reserve" has a special meaning in the law of insurance, that in general it means "a *sum of money*" which is *set aside*, "*reserved*," as a *fund*. 251 U.S. at 350[10] (emphasis added). Since 1922 the Treasury's regulations have provided that while "a company is permitted to make use of the highest aggregate reserve called for by any State in which it transacts business, . . . the reserve must have been *actually held* as shown by the annual statement." See Regulations 62, Art. 681 (1922 ed.) (emphasis added).

The Treasury's Regulations still provide today that "in determining total reserves, a company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been *actually held* during the taxable year for which the reserve is claimed." Treas. Reg. Section 1.801-5(a)(3). (Emphasis added.) The unam-

---

[10] Until the Revenue Act of 1942, a life insurance company was actually defined in terms of the "reserve *funds*" it held. *See, e.g.*, Section 242 of the Revenue Act of 1921, 42 Stat. 227; *cf.* Section 801(b), Int. Rev. Code of 1954.

biguous requirements of this long-standing Regulation leave no place for an unfunded "reserve liability" that is not actually set aside out of the premiums received by the insurance company.

Aside from confirming that the term "reserve" means a sum of money, the "actually held" requirement serves a salutary purpose in the administration of the income tax law. Without it, a company could claim life insurance reserves for tax purposes based on the most conservative mortality tables and interest assumptions allowed by state law, while actually keeping a lower reserve based on more reasonable assumptions in its own business. Or a company could compute a deduction for the increase in its unearned premium reserves during the year by calculating unearned premiums on a pro-rata basis for tax purposes while actually maintaining lower unearned premiums under the "Rule of 78."[11] If the Treasury really means to abandon its "actually held" requirement, it should look to all the consequences.

These Regulations also evidence a longstanding Treasury policy that Federal income tax authorities should not become enmeshed in technical determinations as to the amount or sufficiency of state regulatory reserve requirements. See *Lamana-Panno-Fallo Industrial Ins. Co.* v. *Commissioner,* 127 F.2d 56, 58-59 (5th Cir. 1942), where the court said:

---

[11] The Rule of 78 is like the "sum of the years digits" method of computing depreciation. See Treas. Reg. Section 1.167(b)-3. For example, if an insurance company receives a $360 premium for three years' insurance coverage, the unearned premium at the end of the first year would be $240 under a pro-rata method (⅔ times $360), but only $180 under the Rule of 78 (2 plus 1 divided by 3 plus 2 plus 1 times $360). See Finding 10, Pet. App. 34a-35a.

> "It is not the function of the Commissioner to review the decision of the State insurance department as to the sufficiency of the reserves or the solvency of the company. There is no federal policy to tax discriminatorily a life insurance company whose reserves may be deficient or depleted .... [The predecessor of Treas. Reg. Section 1.801-5(a)(3)] . . . provides that 'a company is permitted to make use of the highest aggregate reserve called for by any State * * * in which it transacts business, but the reserve must have been actually held.' We find no provision in Statute or Regulation looking to a demand on the Commissioner's part for larger reserves that [sic] the State has required."

See also *Alinco Life Ins. Co.* v. *United States,* 373 F.2d 336, 345 (Ct. Cl. 1967).[12]

---

[12] Whether or not unearned premiums must be required by law (see Pet. Br. p. 60, fn. 19), petitioner is not free to disregard the decision of State regulatory authorities that reserves are not required. *Cf.* Maryland Casualty Co. v. United States, 251 U.S. 342, 349 (1920); Commissioner v. Idaho Power Co., 418 U.S. 1, 14-15 (1974); Commissioner v. Lincoln Savings & Loan Assn., 403 U.S. 345, 355-356 (1971). This Court's prior decisions on reserve issues, cited by petitioner in its footnote 19, merely distinguish technical insurance reserves from solvency reserves and do not suggest that the Court is prepared to substitute its judgment on actuarial matters and state regulatory requirements for that of the actuaries and state authorities charged with the interpretation and execution of insurance laws. There is only one case of which we are aware in which unearned premiums were included in the reserve test even though supposedly not required by law, *see* National Protective Ins. Co. v. Commissioner, 128 F.2d 948 (8th Cir. 1942), but even there the unearned premiums were actually held by the company charged with them and were held, moreover, pursuant to a written agreement with the State Superintendent of Insurance and carried as a liability by the taxpayer in its annual statements.

C. The Unearned Premiums Attributed to Respondent Were Neither Reported by Respondent on Its Annual Statements Nor Accepted by State Regulatory Officials of Missouri as Required by Treas. Reg. Section 1.801-5(b).

Before, during and after the trial of this case, and on its appeal from the trial judge's decision to a three-judge panel of the Court of Claims, petitioner took the position that it was "irrelevant to tax treatment" that the State of Missouri did not require respondent to maintain unearned premium reserves under its reinsurance treaties with Pilot and National Fidelity.[13] Then, as explained by the Court of Claims in its opinion below (Pet. App. 21a):

> "At a later stage in this litigation the court itself injected an issue which had not been presented to the trial judge or to the three-judge panel of the court which first heard the argument. As a result of the decision by a different trial judge in *Consumer Life Ins. Co.* v. *United States,* No. 463-70, the court ordered the parties to brief and argue the question of whether *state law* required the taxpayer to establish an insurance reserve for the unearned premiums involved here. (If so, the case would be governed by Section 801(c)(3), . . . and the taxpayer would lose.) The case was then ordered to be heard *en banc.*[3]

"[3] This was done before the three-judge panel had rendered its decision."

In its *en banc* decision, the Court of Claims held that respondent was not required by Missouri law to main-

[13] *See, e.g.,* Defendant's Submission in Response to Pre-Trial Order Under Rule 111, p. 25; Brief for the United States to Commissioner Fletcher, p. 27; Brief and Exceptions for the United States, pp. 6, 17; Reply Brief for the United States, p. 3.

tain unearned premium reserves, basing its conclusion on findings made by the trial judge on uncontradicted evidence and noting that the text of the Missouri statutes relied upon by petitioner "fully harmonizes with the interpretation of Missouri law spelled out in our findings and followed by the Missouri insurance administrators, *i.e.*, that Missouri law did not during the years in question require this taxpayer to set up the reserves in question."

Petitioner's attempt to raise the issue anew cannot be sustained on the record of this case. Petitioner stipulated that respondent maintained no unearned premium reserves with respect to its reinsurance of Pilot and National Fidelity and reported no such reserves on its annual statements to the insurance authorities of Missouri (Finding 16, 26, Pet. App. 38a-39a, 46a-47a); that the Missouri Division of Insurance twice audited respondent for the period in which these reinsurance treaties were in force (Finding 28, Pet. App. 47a-48a); and that the Missouri Division of Insurance did not require respondent to establish unearned premium reserves (Finding 29, Pet. App. 48a-49a).

Furthermore, the expert witness in this case testified that no state regulatory authority would impose an unearned premium reserve requirement on an insurance company where, as under respondent's disability reinsurance treaties with the ceding companies, such company did not receive premiums in advance for insurance to be provided in the future. (Finding 29, *supra.*) With respect to this testimony, petitioner stipulated that the expert was "familiar with the standard valuation laws in force in all 50 states, and with the requirements and examination procedures of the National Association of Insurance Commissioners."

These facts *compel* a finding that respondent is not chargeable with a "reserve required by law" within the meaning of Section 801(c)(3). Though once again petitioner chooses not to acknowledge its own Regulations, the definition of "reserves required by law" prescribed therein requires that the reserve be "reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries." Treas. Reg. Section 1.801-5(b). Those requirements plainly were not met here.

The language of the Regulations mocks petitioner's argument that "the state insurance officials' failure to require the taxpayers to establish A&H reserves can hardly be dispositive of the question whether those reserves were 'required by [state] law' under Section 801(c)(3)." (Pet. Br. 67). The principles of *Commissioner* v. *Estate of Bosch,* 387 U.S. 456 (1967), can hardly be applicable when acceptance of the reserve by state regulatory authorities is given controlling weight by petitioner's own Regulations. Further, this Court long ago rejected the idea that the reserve requirements of state regulatory authorities may be disregarded in determining when reserves are "required by law." *Maryland Casualty Co.* v. *United States,* 251 U.S. 342, 349 (1920). Finally, the highest court of Missouri has spoken on the question of whether the laws of that state contemplate a reserve for premiums that have not been collected.

> "[U]ncollected premiums [may] not be counted as part of the [unearned premium] reserve, for the latter must always be available." *State ex rel. American Central Insurance Co.* v. *Gehner,* 320 Mo. 901, 9 S.W.2d 621, 624 (1928).

In "proving" that respondent was required by Missouri law to maintain unearned premium reserves, petitioner's principal reliance is not on the record in this case, where it chose not to introduce any evidence, but on testimony of insurance examiners from states other than Missouri, which was received in unrelated cases, where it was rejected in *Consumer Life* and apparently disregarded in *First Railroad* (where the issue was entirely different in any event). In none of those cases did the insurance authorities actually attribute reserves under a "reserves follow the risk" principle. The expert in this case testified that he never heard of any state that has ever done so.[14] Even the Seventh Circuit in *Economy Finance* conceded that reinsurers paid on a monthly earned premium basis "could not establish an unearned premium reserve, because the premiums were not received until they were fully earned." *See Economy Finance Corp.* v. *United States,* 501 F.2d at 471.

Petitioner's contentions regarding Missouri law are discussed in the footnote below.[15] Particularly in view

---

[14] A. 188.

[15] Petitioner's citation of Section 376.410(4) of the Missouri statute (Pet. Br. 73), providing that "proper credit shall be allowed for reinsurance in other companies licensed to do business in this state," deals only with the reserve requirements of ceding companies and does not authorize attribution to a reinsurer of a reserve it does not hold. The expert witness in this case explained that such provisions allow credit for reinsurance only where the reserve is actually transferred to the reinsurer, and not otherwise. (Finding 19, Pet. App. 43a-44a.)

Section 375.246 of the Missouri statute, cited by petitioner in its footnote 20 (Pet. Br. 73), gives the Missouri Director of Insurance authority to disallow a credit if he finds that the reinsurance transaction has been arranged "for the purpose principally of deception as to the ceding company's financial condition," including the type

of its Regulations, it seems more than a little presumptuous of petitioner to suggest that a tax lawyer's analysis of the insurance laws of Missouri should be regarded as authoritative as against the contrary interpretation of the state regulatory officials entrusted with the execution of those laws and the uncontradicted testimony of an expert familiar with the insurance laws of all 50 states.

There is no rationale consistent with the statute, Regulations and past decisions of this Court for accepting petitioner's contention that the unearned premiums it seeks to attribute to respondent were "required by law" despite the fact that the Missouri Insurance Department never required them. Should this Court disagree, however, it seems only fair, in view of the late stage at which the issue was raised, and the fact that respondent was misled by petitioner's

---

of arrangement described in petitioner's footnote. There was no reason for the expert to consider that provision in this case when petitioner has conceded that these reinsurance agreements were bona fide. Further, that provision was enacted in 1967, after the years in issue in this case.

Presumably petitioner does not offer the Hammond treatise cited in footnote 27 (Pet. Br. 72) as an authoritative exposition of Missouri law. The accounting treatment prescribed therein is concerned with cases in which the reinsurer has some contractual right in funds "deposited with" the ceding company. It is stipulated in this case that Pilot and National Fidelity did not credit, set apart, or make the unearned premium reserves available to respondent, and indeed invested and received the income from those reserve funds for their own account. Compare Thompson, *Reinsurance* (4th ed. 1966), at p. 174: "If the excess premium is to be paid on a quarterly basis, that is of course each three months, as a rule there is no deposit premium paid. The ceding company merely reports the net premiums quarterly and pays accordingly. Then the excess reinsurance premiums are earned when paid and do not enter into the premium reserve."

previous position that it considered state law "irrelevant" to the issues, that the case be remanded to give respondent the opportunity of introducing further evidence on the insurance reserve requirements of Missouri.[16]

II. THE STATUTE AND REGULATIONS DEFINE A LIFE INSURANCE COMPANY IN TERMS OF RESERVES HELD, NOT RISKS ASSUMED.

A. It Was Not the Purpose of Congress To Go Beyond the Reserves Actually Held by a Company to Determine the Nature of Its Business.

While petitioner now insists that the statutory language of Section 801 supports an attribution rule, the Seventh Circuit in *Economy Finance* was candid enough to admit that attribution could not be supported by "a literal interpretation of § 801(a) . . ." See *Economy Finance Corp.* v. *United States,* 501 F.2d 466, 477. Moreover, there is no evidence in the meager amount of legislative materials available[17] that Con-

---

[16] During the discovery stage of this litigation, counsel for petitioner and respondent agreed upon a list of questions to be put to officials of the Missouri Division of Insurance and the Government's expert in the Department of Insurance of the State of Illinois. Those officials responded categorically that they would not require respondent to maintain an unearned premium reserve under its treaties with the ceding companies and that their departments had never attributed reserves to a reinsurer under monthly earned premium treaties. That is why petitioner lost interest in the state law issue and regarded it as "irrelevant" until the rehearing *en banc* below.

[17] The Committee reports on Section 242 of the Revenue Act of 1921, the first predecessor of Section 801(a), do not even mention the reserve test. *See* H.R. Rep. No. 350, 67th Cong., 1st Sess. (1921), 14; S. Rep. No. 275, 67th Cong., 1st Sess. (1921), 20.

gress intended the Internal Revenue Service or the courts to disregard the language of the statute and look beyond reserves actually held by insurance companies in accordance with state law and actuarial principles or to independently "scrutinize" the insurance company's business "in order to determine the source and significance of the resulting distortion when the reserve qualification formula is literally applied." *Ibid.*

We agree that "Congress employed the reserves concept as the proper measure of the amount and character of a company's insurance business for purposes of determining its tax status." (Pet. Br. 47).[18] That does not justify a "reserves follow the risk" rule however. What petitioner proposes is not a test "measured by *their* reserves," as Dr. Adams of the Treasury Department testified in 1921 (Pet. Br. 46), but a test looking to risks which the company has agreed to insure against in the future, *whether or not* it holds or needs to hold reserves against those risks.

The Seventh Circuit in *Economy Finance* cited no legislative materials to support attribution, but relied on its analysis of the present scheme for taxing life insurance companies as enacted by Congress in the Life Insurance Company Income Tax Act of 1959, 73 Stat. 112.

---

[18] Petitioner so construes the testimony of Dr. T. S. Adams before an executive session of the Senate Finance Committee holding hearings on the Revenue Act of 1921. Petitioner errs, however, in going further and urging that the testimony of that Treasury official be taken as authority for the proposition that an unfunded liability based on risks assumed should be included in the reserve test, when the Treasury's official interpretation of that Act from 1922 to the present time has been that only reserves "actually held" may be claimed in the reserve ratio. See pp. 27-30, *supra*.

> "By defining life insurance companies in terms of the reserves they held, Congress identified the fund which represents, *inter alia,* nonexcess risk. Ignoring for our purpose the fact that H & A reserves also include loading,[19] Congress compared the actuarial estimate of the amount necessary to cover life contract obligations with the amount necessary to cover H & A obligations. By identifying the holders of nonexcess risk it would also identify the holder of excess risk and presumably there is a correspondence between the stated amount of nonexcess and excess risk exposure. Hence the larger the amount of nonexcess risk, the larger the excess risk exposure. For life insurance it is the existence of excess risk not currently ascertainable which mandates the deferral of 50 percent of gain from operations." *Economy Finance Corp.* v. *United States,* 501 F.2d at 477.

The argument that the reserve must follow the "excess risk" to effectuate the Congressional purpose for deferral overlooks the fact that there was no deferral when the reserve test was enacted in 1921.[20] Gain from operations was not taxed at all under the different statutory scheme which existed at that time. This

---

[19] We will return later to the Seventh Circuit's cavalier dismissal of the crucial loading factor. See pp. 42-44, *infra.*

[20] The Court of Appeals was also misinformed by the Government about the extent of the deferral allowed to life insurance companies under the 1959 Act. The Government argued that deferral could be terminated "only when and if the [life insurance] company takes appropriate actions by distributing the tax-deferred amounts to its shareholders. *See* Economy Finance Corp. v. United States, 501 F.2d at 476. In fact, Congress prescribed statutory rules which limit the amount that can be deferred by a life insurance company, depending not upon its own voluntary actions but upon the amount of its life insurance reserves or premium receipts for the year. *See* Section 815(d)(4), Int. Rev. Code of 1954.

exemption was not due to an "excess risk" theory but to Congress' belief that the premium receipts of life insurance companies "were not true income but were analogous to permanent capital investment." *Helvering* v. *Oregon Life Ins. Co.*, 311 U.S. at 269.

Whatever one may think of the Seventh Circuit's argument, the following observation seems apt: "the plain, obvious meaning of the statute is always to be preferred to any curious, narrow, hidden sense that only the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover." *Old Colony Railroad Co.* v. *Commissioner*, 284 U.S. 552, 560 (1932); *Lynch* v. *Alworth-Stephens Co.*, 267 U.S. 364, 370 (1925).

B. Mandatory Attribution Is Inconsistent With the Optional Attribution Rules Prescribed by Congress in Section 820, and With the Internal Revenue Service's Position in Rev. Rul. 70-508.

If analysis of the 1959 Act suggests any legislative purpose regarding reserve attribution, it is that Congress did *not* contemplate mandatory attribution of reserves under a "reserves follow the risk" principle.

The Seventh Circuit did not come to that conclusion because its analysis completely missed Section 820 of the Code, added by the Life Insurance Company Income Tax Act of 1959, 73 Stat. 112, 137, in which Congress prescribed an *optional* reserve attribution rule for reinsurance agreements substantially similar to those in the case at bar. In these transactions, called "modified coinsurance," "the reinsurer accepts all of the obligations it would assume under a conventional coinsurance policy, but the initial insurer retains the reserves and administers the investment of the reserve

funds. However, [unlike the instant case], the initial insurer pays over the gross investment income, less additions to reserves, to the insurer." *See* S. Rep. No. 291, 86th Cong., 2d Sess. (1959) 38-39.

Attribution under petitioner's proposed rule would be inconsistent with the fact that Congress did not give the Commissioner of Internal Revenue power to require attribution in the modified coinsurance transaction. Indeed, by failing to consider Section 820, the Seventh Circuit unintentionally introduced an anomaly into the statute: under its decision, a reinsurer may successfully avoid reserve attribution if the ceding company pays it the gross investment income from the reserve in a modified coinsurance transaction, but may not resist attribution when the ceding company not only holds the reserve but keeps the investment income.[21]

It is also impossible to square petitioner's position in this case with the Internal Revenue Service's holding in Rev. Rul. 70-508, 1970-2 Cum. Bull. 136. In that

---

[21] Petitioner argued below that Section 820 had no bearing on this issue because the optional attribution rule prescribed therein does not apply "for purposes of section 801". *See* Section 820(a), Int. Rev. Code of 1954. But this exception can only mean that Congress understood that the ceding company would be entitled to claim the reserve for purposes of Section 801 even though the parties had elected attribution to the reinsurer for other purposes. There would have been no reason for Congress to exclude Section 801 from the effect of reserve attribution under Section 820 had it believed that the reserve was attributable to the reinsurer for the purposes of Section 801 anyway under the "reserves follow the risk" rule. Further, the Internal Revenue Service has ruled that where the optional attribution rules of Section 820 are not elected, the reserve remains with the ceding company for purposes of Section 801 and is not attributed to the reinsurer under a reserves follow the risk rule. *See* Rev. Rul. 70-508, 1970-2 Cum. Bull. 136, discussed in the text following this footnote.

ruling, the Internal Revenue Service held that the ceding company under a modified coinsurance agreement was entitled to claim the life insurance reserves it held on reinsured risks for purposes of Section 801(b) of the Code. This was a stronger case for attribution than the present one because the ceding company paid over the investment income from the reserve to the reinsurer. Furthermore, the Regulation which defines "life insurance reserves" contains a provision (not found in any of the Regulations applicable to this case) which seemingly supports a reserves follows the risk rule. In Treas. Reg. Section 1.801-4(a), defining "life insurance reserves", the Regulations state:

> "[R]eserves held by the company with respect to the net value of risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves."

Even with this authority, the Service did not require attribution to the reinsurer or disallow the reserve in the ceding company's hands. It held that these Regulations merely prevent both the ceding company and the reinsurer from maintaining reserves on the same risk. So long as the ceding company actually holds the reserve, and the reinsurer does not, the ceding company may properly claim the reserve under Section 801(b) of the Code.[22]

---

[22] Petitioner argued below that the ceding company in Rev. Rul. 70-508 was assumed to have already qualified as a life insurance company, and that the ruling was concerned only with the ceding company's ability to claim the reserve for purposes of taxation and not for purposes of qualification under Section 801. The distinction is spurious. The ruling held that the ceding company was entitled

C. Petitioner Misapplied Its Reserves Follow the Risk Rule by Attributing Gross Rather Than Unearned Net Premiums to Respondent.

Nothing better illustrates the faulty premise of the "reserves follow the *risk*" rule than the insistence of the Seventh Circuit and petitioner upon attributing the entire unearned *gross* premium reserve which includes substantial amounts of unearned "loading" charges that have nothing whatever to do with accident and health *risks*. Loading charges are not held to pay insurance claims but represent amounts charged to policyholders for commissions, overhead and profit. Finding 30, Pet. App. 49a. Unearned loading charges are reserved by the issuing company because it has an obligation to refund them in the event of premature cancellation of the policies. But a reinsurer who never receives premiums paid in advance has no such obligation.

To the extent that the unearned gross premium reserve exceeds unearned *net* premiums, *i.e.*, that part of the reserve which represents the actuarially computed morbidity cost of carrying the accident and health risks, it "is not a true insurance reserve at all, but rather a solvency reserve . . ." Finding 32, Pet. App. 50a. It is of crucial significance in this case that life insurance reserves, with which unearned premiums are compared in the Section 801 reserve test, are calcu-

---

to claim a "life insurance reserve" for purposes of Section 801(b). That section applies for purposes of all the sections of the Code dealing with life insurance companies, including the Section 801(a) reserve test. See Section 801(b), Int. Rev. Code of 1954. *See also* Treas. Reg. Section 1.801-3 and Treas. Reg. Section 1.801-4(a) (to which Treas. Reg. Section 1.801-3(f) refers) which confirm that the term "life insurance reserves" as defined in Section 801(b) applies for purposes both of defining and taxing life insurance companies.

lated solely on an actuarially computed *net* premium (risk only) basis. Thus, the reserve test is meaningless unless life insurance reserves are compared with unearned *net* premium reserves on accident and health risks, excluding loading. (See Finding 36, Pet. App. 55a).

Treas. Reg. Section 1.801-3(e) supports that view. Its definition of "unearned premiums" includes only "those amounts *which shall cover the cost of carrying the insurance risk* for the period for which the premiums have been paid in advance." (Emphasis added). The Court of Claims and the Court of Appeals for the Fifth Circuit have concluded that the phrase "cost of carrying insurance risk" as used in the Regulation refers only to the unearned *net* premiums, excluding "loading." *See Alinco Life Insurance Co.* v. *United States,* 373 F.2d 336, 352 (Ct. Cl. 1967); *Great Commonwealth Life Insurance Co.* v. *United States,* 491 F.2d 109, 113 (5th Cir. 1974). *Contra: Economy Finance Corp.* v. *United States,* 501 F.2d at 482-483; *Superior Life Ins. Co.* v. *United States,* 462 F.2d at 951.

That approach is also supported by the legislative history. The paragraph in the House Ways and Means Committee report from which Treas. Reg. Section 1.801-3(e) takes its definition refers to the "cost of carrying" a risk not only in defining the term "unearned premiums" but on two other occasions where the phrase is unmistakably used in an actuarial (net premium) sense.

> "The pro rata unearned premiums are the amounts which will cover the *cost of carrying the insurance risk* for the period for which the premium has been paid in advance. The life insurance reserves . . . as they pertain to noncancellable

> health and accident insurance policies are those amounts that must be reserved, in addition to pro rate unearned premiums, to provide for the additional *cost of carrying* such policies in later years when the insured will be older and subject to greater risk and when the *cost of carrying* the risk will be greater than the premiums then being received." H.R. Rep. No. 2333, 77th Cong., 2d Sess. (1942), 109. (Emphasis added).

Petitioner conceded below that "the second and third uses of the word 'cost' in the Committee report when referring to the additional cost for carrying risks in later years, refers only to morbidity [actuarial] costs. . . ." See Reply Brief for the United States in *Penn Security Life Insurance Company* v. *United States,* p. 14. It is unlikely that the Ways and Means Committee would have employed the same phrase in the same context three times in the same paragraph and not have intended the same meaning.

Whatever the "cost of carrying the insurance risk" may mean in other contexts, moreover, petitioner cannot logically compel attribution of "loading" under the pretense of obtaining the measure of an insurance company's estimated liability to pay claims on non-life insurance risks Having anchored its argument for a "reserves follow the risk" rule on repeated assertions that an unearned premium reserve "reflects an insurance company's liability to meet casualty insurance claims," (Pet. Br. 41) [23] petitioner clearly may not

---

[23] *See also* Pet. Br. 31 ("the purpose of an insurance reserve is to meet claims under the policies"), Pet. Br. 32 ("the unearned premium reserve represents the potential liability to the policyholder"), Pet. Br. 40 ("an unearned premium reserve represents the measure of the liability of an insurance company to meet claims for short-term casualty coverage"), Pet. Br. 47 ("the function of insurance reserves is to provide a fund to meet future policyholder claims"), Pet. Br. 50 ("the function of an insurance reserve is to represent the insurer's estimated liability to the policyholders").

attribute solvency reserves that are not needed to meet casualty insurance claims under that rule.[24]

D. If There Is To Be Any Modification in the Section 801 Reserve Test, It Should Be Made by Congress on a Prospective Basis.

Part I, Subchapter L, Chapter 1 of the Internal Revenue Code, dealing with life insurance companies, is a carefully wrought, interrelated set of provisions defining a scheme of taxation that is unique to that industry. Congress created a whole new tax lexicon for life insurance companies, and throughout these

---

[24] Should this Court decide that petitioner has the power to reallocate reserves, but may attribute only the net (risk) premium portion allocable to the cost of carrying the insurance risk (*i.e.*, the cost of meeting casualty insurance claims), respondent's life insurance company status will not be affected. Finding 34, Pet. App. 52a.

Contrary to the assertion made on page 48, fn. 11 of petitioner's brief, respondent has also consistently maintained at all stages of this litigation that unearned premiums held under the credit life insurance policies issued by Pilot and National Fidelity qualified as unearned premiums on "noncancellable life, health or accident policies" includible in the numerator as well as the denominator of the 50 percent test. Section 801(a)(2). *See* Alinco Life Ins. Co., v. United States, 373 F.2d at 354. In Helvering v. Oregon Ins. Co., 311 U.S. at 270-71, this Court said: "It seems clear that Congress intended to permit the deduction of reserves based on those policies that make a company a 'life insurance company' under the Act, which, by definition, includes policies of 'combined life, health and accident insurance' . . . . Here, in the combined life and health and accident policies, the health and accident reserves are based upon contingencies of commencement and continuance of disability. They have a direct and inseparable relationship to the very insurance contracts which bring [the taxpayer] under a special tax scheme." *See also* Finding 35, Pet. Br. 53a, stating that Pilot's and National Fidelity's credit life insurance policies were conceptually identical to combined life and accident and health insurance contracts issued by insurance companies since the early part of this century.

sections one finds unfamiliar technical terms that only a member of the industry would understand. Accountants and lawyers do not suffice to complete a life insurance company's tax return; an actuary is essential.[25]

In this case, the Court is called upon to redefine terms and concepts that are basic to the entire statutory scheme and already have well established meanings in the insurance industry. A holding that the "reserves" of an insurance company include unfunded liabilities would create ripple effects throughout Subchapter L. The peculiar construction petitioner urges for "unearned premiums" in Section 801 of the Code, the basic definitional provision for the life insurance company sections, would be applicable at least for purposes of all of "part I, subchapter L, chapter 1 of the Code," the life insurance company provisions. Treas. Reg. Section 1.801-3.

---

[25] "It is well established that the technical provisions of Section 801 (and its predecessors) were couched by Congress in language peculiar to the insurance industry and therefore intended to have the meaning generally attributed thereto by the experts." *Alinco Life Ins. Co.* v. *United States*, 373 F.2d at 352, citing 8 Mertens, Law of Federal Income Taxation (1970 revision) § 44.15, in particular footnote 11. The Mertens treatise quotes Dr. T. S. Adams, a former tax advisor to the Treasury, who testified before the Senate Finance Committee on the phraseology of the provisions in the Revenue Act of 1921 which first defined and specially taxed life insurance companies (Senate Finance Committee Hearings on H.R. 8245, 67th Cong., 1st Sess. (1921), at 87, 92):

> "Only experts are interested . . . that language merely repeats the language of the present law, language which the companies themselves proposed and which they understand . . . Every word of the phraseology of that section has been gone over by insurance experts of the very highest caliber. Only a few people are involved. The public is not interested in this, they do not have to read it, and the people who deal with it are experts. Every word of that phraseology was presented to the insurance officials, and only those companies who are involved must understand it."

The consequences to this complex scheme of rewriting Section 801 may be "opaque," but they are bound to be significant, perhaps in ways that cannot now be anticipated. *See* Pet. App. 18a. *See also Economy Finance Corp.* v. *United States,* 501 F.2d at 485-86 (dissenting opinion). Some of the questions and problems which immediately appear are the following:

—Will attribution be required if the parties do not put a "run-off" provision in their reinsurance agreement (see fn. 8, p. 26, *supra*)? If so, can the rule be efficacious if it is so easily avoided? If not, how can petitioner justify attributing a long-term liability to a company that can cancel its liability at any time?

—Does the rule apply where reinsurance is not involved? For example, it is not uncommon for insurance companies to issue policies to individuals on the same "earned premium" mode of payment used in respondent's reinsurance agreements with Pilot and National Fidelity.[26] If petitioner is correct in contending that a reserve liability arises from a mere agreement to insure in the future, whether or not premiums have been collected in advance for such insurance, will not direct insurers as well as reinsurers have "unearned premiums" attributed to them? *But see*

---

[26] The Hammond treatise cited by petitioner (Pet. Br. pp. 40, 72), notes that "in certain types of insurance contracts, particularly in large group accident and health policies, the premium is not paid by the policyholder to the insurance company until after the premium is earned. In premium transactions of this type unearned premiums are not involved". Hammond, *Insurance Accounting, Fire and Casualty* (2d ed. 1965), 177. The expert witness in this case testified to the same effect. A. 189-190.

Great Commonwealth Life Ins. Co. v. *United States,* 491 F.2d 109, 113 (5th Cir. 1974) (premiums as yet unpaid by policyholders cannot be "unearned premiums"). Or will attribution in such cases depend upon whether the policyholder has cash in his bank account equal to the amount of premiums he has agreed to pay the insurance company in the future?

—What is the proper amount to be "attributed" to a company that has assumed a risk? Petitioner assumes that the reserve attributable to the reinsurer should be the same as the reserve in the hands of the ceding company. Obviously, that measure of liability will not be available in the case of a direct insurer issuing policies on an earned premium basis. Furthermore, since the Code normally gives wide latitude to the individual insurance company to determine the amount of its reserve liabilities, why should a reinsurer not be entitled to select its own actuarial assumptions regarding its "attributed" liability to pay estimated future claims on reinsured policies?

—If the Internal Revenue Service is permitted to attribute unearned premiums held on reinsured policies to the reinsurer, should not a reinsurer be permitted to similarly claim life insurance reserves held by a ceding company on reinsured risks, whether or not the ceding company has agreed to (or is able to) elect attribution under Section 820? *But see* Rev. Rul. 70-508, 1970-2 Cum. Bull. 136. Or will petitioner argue in future cases that life insurance reserves cannot be attributed because the reinsurer failed to report them on its

annual statements and they were not otherwise "required by law" within the meaning of its Regulations?[27]

—Will companies be permitted to claim deductions based upon hypothetical reserves attributed under the reserves follow the risk rule? *See* Treas. Reg. Section 1.801-3, which suggests that they must be permitted to do so. Note that this results in deductions against the real income of a life insurance company for hypothetical reserves which the company will never set aside out of income for the payment of policyholders' claims. *See, e.g.,* Sections 805, 809(a)(2), 809(d)(2), 810(c), Int. Rev. Code of 1954.

—Will the rationale for the reserves follow the risk rule lead ultimately to the conclusion that any reserve held in respect of a policy which is not long-term, and which therefore does not fit the "legislative purpose" behind deferral of underwriting gain, must be treated as a disqualifying reserve in computing the life insurance company reserve test? *See Economy Finance Corp.* v. *United States,* 501 F.2d at 486 (fn. 7) (dissenting opinion).

---

[27] Petitioner contends that "unearned premiums" need not be required by law and so are not subject to this requirement. (Pet. Br. 60 (fn. 19)). Suppose, however, that R holds $10,000 of its own life insurance reserves and, in addition, reinsures a ceding company that holds $50,000 in reserves on life insurance risks reinsured with R and $15,000 in unearned premiums on accident and health risks also reinsured with R. Will application of petitioner's "reserves follow the risk" rule result in attribution only of the unearned premiums with the result that R will fail to qualify as a life insurance company?

The results of applying the terms of Section 801 as written to this case are not absurd nor contrary to the legislative purpose. *See Commissioner* v. *Brown,* 380 U.S. 563, 571 (1965). There is nothing shocking in finding that a company that reinsures more life insurance benefits then accident and health benefits, and that maintains more life insurance reserves than accident and health insurance reserves in accordance with actuarial standards and state regulatory requirements, qualifies as a life insurance company for purposes of taxation under the Internal Revenue Code. It would be astonishing if it did not.

The reasons for refusing petitioner's invitation to rewrite the statute in the instant case are no less compelling than those given by the Court in *Commissioner* v. *Brown.* There, petitioner argued that the transfer of a business to a tax-exempt organization did not qualify as a "sale" because the risk of the business remained on the seller. The Court refused to accept that argument because:

> 1. It changed the commonly accepted meaning of the term "sale." 380 U.S. at 570-571. Similarly, petitioner now would change the meaning of the terms "unearned premiums" and "reserves" as understood not only in the insurance industry but as defined in its own Regulations, to make them fit the procrustean bed of its "reserves follow the risk" theory.
>
> 2. The term "sale" is used a great many times in the Code; the Court was not prepared to accept the "wide ramifications" that the petitioner's new definition would provoke in other cases. 380 U.S. at 575. The ramifications of pe-

titioner's reserves follow the risk rule, though presumably limited to the insurance industry, would be at least as profound.

3. Petitioner's solution to the "loophole" alleged in *Brown* involved a clear case of "overkill" because it denied capital gains treatment to the *seller* in order to prevent tax-exempt *buyers* from trading on their tax exemptions. 380 U.S. at 579. In this case, petitioner's shotgun approach would disqualify a life insurance company whose principal business was reinsuring life insurance benefits in order to prevent abuses in other cases.

4. The Court ultimately concluded that it was wise policy to "leave to the Congress the fashioning of a rule which in any event must have wide ramifications." 380 U.S. at 579.[28] Given the technical and specialized provisions of the Code involved here, that policy is especially appropriate in this case.

If there are in fact any defects in the reserve test,[29] only Congress can deal with the entire subject matter comprehensively and fairly. For example, it can deal with the problem of the incomparability of life insurance reserves and unearned gross premium reserves (if the problem has not been taken care of already by the Regulations). Of equal importance, Congress can

---

[28] Congress did address the problem of the bootstrap sale in a comprehensive scheme thereafter. *See* Section 514, Int. Rev. Code of 1954.

[29] In view of Congress' treatment of modified coinsurance in Section 820 it cannot be assumed that Congress would consider the present reserve test to be defective for lack of a reserves follow the risk rule.

treat with these matters on a prospective basis. It is unfair to impose the harsh penalty of disqualification from life insurance company status on companies that had no notice of the Internal Revenue Service's *ad hoc* rulemaking until after their tax returns were audited.[30]

Petitioner's own Regulations led respondent and the "several dozens of [other] companies" that have entered modified coinsurance type reinsurance agreements in past years[31] to believe that they would be judged under Section 801(a) on the basis of the reserves they actually held as reported to and accepted by state insurance authorities, and that premiums that had not been paid to them in advance would not be treated as "unearned premiums". To this very day, petitioner has not amended nor qualified those Regulations. It has never given notice of its "reserves follow the risk" rule in the Federal Register. In these circumstances, even if petitioner's new interpretation of Section 801 had merit, the Revenue Service cannot be allowed to change its position on an *ad hoc* basis to the prejudice of companies that relied on its prior interpretation of the statute. *See Vogt* v. *United States,* 537 F.2d 405 (Ct. Cl. 1976). *Cf.* 5 U.S.C. § 552(a); *Morton* v. *Ruiz,* 415 U.S. 199, 230-236 (1974); *United States* v. *Leslie Salt Co.,* 350 U.S. at 396.

---

[30] Note that the consequences of disqualification can extend beyond the taxable year involved to income which was tax-deferred in several prior years. *See* Section 815(d)(2), Int. Rev. Code of 1954 which provides that if an insurance company fails to qualify as a life insurance company in two successive years, tax will be triggered on all of the tax-deferred amounts accumulated in its "policyholders surplus account" during all prior years. Thus, the tax consequences of retroactivity are much more severe than the usual tax case.

[31] See A. 175-176, 196.

III. PETITIONER MAY NOT RECAST FOR TAX PURPOSES TRANSACTIONS BETWEEN UNRELATED PARTIES HAVING SIGNIFICANT NON-TAX CONSEQUENCES.

A. Petitioner's Contention That Pilot and National Fidelity Were Merely "Paymasters" Holding Unearned Premiums "On Behalf" of Respondent is Contrary to the Court of Claims' Findings and the Facts of Record.

Petitioner concedes that this case involves "bona fide reinsurance agreements" (Pet. Br. 54, 74) between unrelated parties (A. 43), but asks that they be treated as mere agency agreements for tax purposes. That is a contradiction in terms. Pilot and National Fidelity were not "paymasters," bankers, or commission agents, as pictured in petitioner's brief, because a ceding company in a "true reinsurance agreement" pays claims and holds reserves in satisfaction of its own liabilities, as Pilot and National Fidelity did in this case, and not on behalf of the reinsurer.[32]

Respondent could not legally have entered into an agency agreement with Pilot and National Fidelity of the kind petitioner describes. It was not licensed to do business outside of Missouri and it would have been illegal for respondent to have issued policies to loan customers of Aetna or to have received unearned premiums from them, either directly or through agents. *Cf. Commissioner* v. *First Security Bank,* 405 U.S. 394 (1972).

---

[32] There is a form of reinsurance, known as "assumption reinsurance", in which the reinsurer actually "steps into the shoes" of the ceding company and becomes solely liable under its policies. *See* Treas. Reg. Section 1.809-5(a)(7)(ii). However, respondent's treaties with Pilot and National Fidelity fell into the more common category of "reinsurance ceded", in which the ceding company remains solely liable to its policyholders. *See* Treas. Reg. Section 1.809-4(a)(1)(iii). *See also* Finding 19, Pet. App. 43a.

The policyholders who paid unearned premiums to Pilot and National Fidelity had contracts solely with those companies, not with respondent. Reinsurance agreements with respondent did not relieve Pilot and National Fidelity of their obligations to their policyholders; the parties took pains to point out that their agreements did not "create any right or legal relation between [respondent] and any person insured or any beneficiary under any policy of [Pilot or National Fidelity] which may be reinsured hereunder." (Exs. 4, 6, A. 44, 83, 95).

If any doubt remains as to the non-tax significance of these facts, imagine the reaction of a policyholder if he were told that one of his insurance policies with a major company was suddenly "without substance" because the policy had been reinsured, that he would have to look instead to the reinsurer with the "ultimate liability," a small company with an unfamiliar name whose capital funds were insufficient to enable it to do business in his state.

The Commissioner cannot "by manipulation of the tax law, preclude . . . [unrelated] parties from exercising business judgment as to the form in which their transactions will be cast when alternate forms have . . . disparate business and legal consequences." *Santa Anita Consolidated, Inc.*, 50 T.C. 536, 558 (1968), *acq.* 1969-2 Cum. Bull. xxv. In particular, the Commissioner may not recast the transaction into a form that would have been illegal under state law. *Commissioner* v. *First Security Bank*, 405 U.S. 394. Even where parties plan their affairs with an eye to the tax consequences, as petitioner assumes on a record that is silent as to this matter, the "fact that a transaction is so arranged that the tax consequences are highly favor-

able to one of the parties affords the Commissioner no license to recast it into one of less advantage." *Lewis & Taylor Inc.* v. *Commissioner,* 447 F.2d 1074, 1077 (9th Cir. 1971). *See Edwards* v. *Commissioner,* 415 F.2d 578, 582 (10th Cir. 1969).[33]

A contrary rule would confound business transactions. Taxpayers are and should be free to arrange their business affairs as they see fit.[34] Indeed, as a corollary of that principle, "[t]his Court has observed repeat-

---

[33] The doctrine of substance over form is not usually appropriate in cases where unrelated parties have dealt at arms-length. *See* Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance,* 77 Yale L. J. 440, 469-470 (1968). Indeed, the doctrine has limits even when a sole shareholder is dealing with his own corporation. Justice (then Judge) Marshall, writing for the Second Circuit in Nassau Lens Co. v. Commissioner, 308 F.2d 39 (2d Cir. 1962) expressed the dangers of carrying the substance over form doctrine too far. "It is all very well to say that it makes little 'economic' difference whether the investment here was divided between debt and equity or was entirely allocated to equity. But by the same reasoning it may make little 'economic' difference to Pildes whether he has an unincorporated business or a corporation in which he is the sole stockholder. And if one wanted to carry the argument far enough, presumably the Commissioner would be free to make *ad hoc* attacks on a whole variety of transactions involving closely held corporations. But this Code does not so empower the Commissioner, for it recognizes and treats corporations as separate entities and affords significance to the type of investment chosen in them so long as that investment has substantial economic reality in terms of the objective factors which normally surround the type chosen." 308 F.2d at 46.

[34] *See also* Commissioner v. First Security Bank, 405 U.S. at 398-399 (fn. 4):

> "Taxpayers are, of course, generally free to structure their business affairs as they consider to be in their best interests, including lawful structuring . . . to minimize taxes. Perhaps the classic statement of this principle is Judge Learned Hand's

edly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not." *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974). Where, as here, the transaction is not a "sham", explainable only in terms of tax avoidance, see *Gregory* v. *Helvering*, 293 U.S. 465; *Knetsch* v. *United States*, 364 U.S. 361 (1960), taxpayers dealing at arms' length should be able to rely on the tax consequences of the route they *have* chosen to follow.

Petitioner does not allege that respondent's reinsurance agreements were "sham transactions". On the contrary, it confirms that they were "bona fide reinsurance agreements." *See*, however, Pet. Br. 62-66, discussing the *First Railroad* and *Consumer Life Insurance Company* (Treaty II) cases. Petitioner does not argue that Pilot and National Fidelity were phantom corporations like the one involved in *Gregory* v. *Helvering, supra.* It does not contend that respondent had side agreements with Pilot and National Fidelity to make the unearned premium reserves or the income therefrom available to respondent. *See Economy Finance Corporation* v. *United States*, 501 F.2d at 477. There is no common control relationship to justify spe-

---

comment in his dissenting opinion in *Commissioner* v. *Newman*, 159 F.2d 848, 850-851 (CA 2 1947):

'Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich and poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.' "

cial scrutiny of the agreement between respondent and the ceding companies. *Cf. Superior Life Ins. Co.* v. *United States, supra.* In short, petitioner offers no ground whatever for disregarding the form of bona fide reinsurance agreements between respondent and unrelated ceding companies and treating them as if they were mere agency agreements.

B. Unearned Premiums Cannot Be Attributed to Respondent Under the Doctrine of Constructive Receipt.

Petitioner's brief is filled with references suggesting that respondent viewed its accident and health reinsurance agreements with Pilot and National Fidelity as a device to "shift" its non-life reserves to the ceding companies temporarily so as to qualify for life insurance company treatment.[35]

It is only petitioner that is "shifting" reserves here under its reserves follow the risk theory. Respondent never had any reserves to "shift." The parties *stipulated* that the unearned premium reserves which petitioner seeks to "shift" to respondent were actually held and invested by Pilot and National Fidelity for their own accounts; that they, not respondent, received the income therefrom; that they did not credit, set apart, or otherwise make these reserves available to respondent; and that neither respondent nor its affiliates controlled either of these companies, directly or indirectly. (A. 49-50; Finding 16, Pet. App. 39a).

---

[35] There is no evidence in this case suggesting tax avoidance motives for these agreements. Even in *Economy Finance*, where the parties stipulated that there were tax reasons for using the monthly earned premium mode of payment, the Seventh Circuit found that business purposes were a "creditable motivation" for reinsuring on that basis. See *Economy Finance Corp.* v. *United States, supra*, 501 F.2d at 471.

So long as funds have not been "credited to [the taxpayer's] account, set apart for him, or otherwise made available . . .", and it is stipulated that the unearned premium reserves in this case were not, there is no basis for attribution of these reserves to respondent. *See* Treas. Reg. Section 1.451-2(a). "A bona fide contract providing for deferred payments . . . [will] be given effect notwithstanding that the obligor might have been willing to contract to make such payments at an earlier time." *Ray S. Robinson,* 44 T.C. 20, 36 (1965), *acq.* 1970-2 Cum. Bull. XXI; *Oliver G. Willits,* 50 T.C. 602, 613 (1968), *acq.* 1969-1 Cum. Bull. 21; *cf. Commissioner* v. *Oates,* 207 F.2d 711 (7th Cir. 1953); Rev. Rul. 60-31, 1960-1 Cum. Bull. 174, 178.[36]

The cases cited by petitioner to support a different result are readily distinguishable. In *Economy Finance,* the ceding company "did not even retain the right to the return on the investment of these reserves during the period of retention." 501 F.2d at 477. Both the reserves and the income therefrom were effectively in the hands of the taxpayers' stockholders in that case.

Superior Life Insurance Co. v. *United States,* 462 F.2d 945 did not involve reinsurance, the unearned premiums were held by the taxpayer's parent company, and the unearned premiums were available to the taxpayer "whenever taxpayer so desired." 462 F.2d at 950. As the Court of Claims explained below, "[s]ince the taxpayer in *Superior Life* 'constructively received'

---

[36] Note that attribution was denied in these cases and rulings even though the income had already been earned by the taxpayer. That result must follow *a fortiori* where petitioner seeks to attribute premiums to respondent before they have even been earned.

unearned premiums under long-accepted principles of tax law, the Fourth Circuit's decision is entirely consistent with the fact that the existence of unearned premium [sic] depends upon the mode of premium payment." (Pet. App. 20a.)

The issue in *Commissioner* v. *Hansen,* 360 U.S. 446 (1959) was whether the taxpayers, automobile dealers, were required to *accrue* income which they had a fixed right to receive, 360 U.S. at 464; here, it is the actual receipt of premiums "paid in advance" that petitioner's Regulations regard as the critical event. Treas. Reg. Section 1.801-3(e).[37] *Hansen* also involved the Commissioner's "broad powers in determining whether accounting methods used by a taxpayer clearly reflect income," 360 U.S. at 467, while the reallocation power petitioner asserts here is not authorized by statute and is contrary to its own Regulations.

Finally, the automobile dealers in *Hansen* actually received the purchase price of their automobiles in the form of notes which they endorsed and negotiated

---

[37] Indeed, attribution would not be justified here even if unearned premiums turned on the right to receive income in the future rather than actual receipt of premiums paid in advance. There is no need to accrue income until *all the events have occurred* which fix the right to receive such income. *See* Treas. Reg. Section 1.451-1 (a). Respondent had no right to receive reinsurance premiums from Pilot and National Fidelity until it had provided reinsurance coverage for a preceding month. Respondent's right in this respect was no different from the right of a landlord to receive monthly rentals for making his premises available to the tenant each month. Unless petitioner is prepared to require landlords, bankers, and others to recognize as income payments that they have a right to receive only after the income has been earned with the expiration of time and the provision of services, it should not use respondent's conditional right to receive premiums in the future as a basis for attribution of "unearned premiums".

to finance companies. It is not surprising that the dealers were required to pay tax on income from automobiles sold and paid for.[38] But the policyholders in this case were *not* respondent's customers, they did not agree to pay respondent any of their premiums, and the ceding companies (respondent's "customers") paid respondent reinsurance premiums only on a monthly basis for reinsurance provided during the previous month.

In summary, petitioner has neither the facts nor the law to justify attribution of unearned premiums from Pilot and National Fidelity to respondent in this case. Respondent's "bona fide reinsurance agreements" with the ceding companies were not agency agreements. The unearned premium reserves maintained by those companies were not credited, set apart or made available to repondent so as to justify application of the doctrine of constructive receipt. And though petitioner "shifts" reserves around as though this was a Section 482 case, that provision is inappropriate here because neither respondent nor its affiliated companies directly or indirectly controlled Pilot or National Fidelity.

---

[38] *Cf.* Rev. Rul. 67-316, 1967-2 Cum. Bull. 171, holding that where an accrual basis automobile dealer receives a non-negotiable note which includes the full amount of finance charges payable over the entire term of the note, but state law requires that the unearned finance charges be refunded to the customer in the event the note is prepaid, the dealer need not take the full amount of the finance charges into income immediately but may include them ratably as earned with the passage of time.

CONCLUSION

For the reasons stated above, the judgment of the Court of Claims should be affirmed.

Respectfully submitted,

JOHN T. SAPIENZA
JOHN B. JONES, JR.
ANDREW W. SINGER

Attorneys for Respondent

Of Counsel:

COVINGTON & BURLING
888 Sixteenth Street, N.W.
Washington, D. C. 20006

OWEN T. ARMSTRONG, ESQ.
LOWENHAUPT, CHASNOFF, FREEMAN, ARMSTRONG & MELITZ
408 Olive Street
St. Louis, Missouri 63102

ROBERT A. KAGAN, ESQ.
320 Park Avenue
New York, New York 10022

JOSEPH KUTTEN, ESQ.
212 South Central Avenue
Clayton, Missouri 63105